

DOCKET SECTION

**BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON, D. C. 20268-0001**

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U.S. DEPARTMENT OF JUSTICE
OFFICE OF THE ATTORNEY GENERAL

POSTAL RATE & FEE CHANGES, 1997

Docket No. R97-1

**INITIAL BRIEF
OF
ALLIANCE OF NONPROFIT MAILERS,
AMERICAN BUSINESS PRESS,
COALITION OF RELIGIOUS PRESS ASSOCIATIONS,
DOW JONES & COMPANY, INC.,
MAGAZINE PUBLISHERS OF AMERICA,
NATIONAL NEWSPAPER ASSOCIATION,
THE MCGRAW-HILL COMPANIES, INC.,
AND
TIME WARNER INC.**

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TABLE OF CONTENTS

STATEMENT OF POSITION.....	1
SUMMARY OF ARGUMENT	2
ARGUMENT	5
I. EXCESSIVE INCREASES IN PERIODICALS MAIL-PROCESSING COSTS REMAIN UNEXPLAINED.	5
A. Witnesses Little and Crain describe the problem.	5
B. Witness Cohen discusses the problem's history and the efforts of mailers and the Commission to persuade the Postal Service to address it.	6
C. The Postal Service knows there is a problem.....	6
D. Degen's direct testimony asserts that his proposed new cost distribution methodology "squarely addresses" the problem, but in fact he ignores the issues raised by Periodicals mailers and proposes a methodology that would make the problem worse.	7
E. Having ignored anomalous cost trends while developing his direct testimony, Degen presents on rebuttal another in the series of last-minute Postal Service "explanations" of the excessive cost increases which, like its ignominious predecessors, explains nothing.	8
F. The record contains no explanation of the tremendous growth in not-handling costs, although these costs play a crucial role in determining attributable costs.....	12
G. Periodicals mailers have made significant efforts to reduce costs, including increased palletization of mail. We support the 3-digit discount which would recognize, in part, those efforts, and we support the moderation recommended by the Postal Service in further Periodicals rate increases.	17

II.	THE TRADITIONAL PRESUMPTION THAT MAIL-PROCESSING COSTS ARE ALMOST TOTALLY VOLUME-VARIABLE HAS BEEN SUBJECTED TO EMPIRICAL INVESTIGATION AND HAS BEEN DISPROVED.	20
A.	There is no substantial evidence – on this or any other record – supporting the supposition that mail-processing costs are almost totally volume-variable.	20
B.	Witness Bradley's production of substantial evidence that volume-variability is well below 100 percent shifts the burden of proof to those who would reject his conclusions.....	24
III.	WITNESS DEGEN'S PROPOSED METHOD FOR DISTRIBUTING MAIL-PROCESSING COSTS WITHIN MODS COST POOLS, WHICH IS PARTIALLY AND INCORRECTLY EMBRACED BY WITNESS SELICK, IS INDEFENSIBLE IF DIVORCED FROM BRADLEY'S ESTIMATED MAIL-PROCESSING COST VARIABILITIES.	25
IV.	DEGEN'S BASIC APPROACH – DISTRIBUTION OF VOLUME-VARIABLE COSTS BY OPERATIONAL COST POOLS – IS CORRECT, BUT HIS OVERLY RIGID AND MECHANICAL APPLICATION OF IT FAILS TO ALLOW FOR THE COMPLEX INTERRELATIONSHIPS AMONG MAIL-PROCESSING OPERATIONS OR FOR THE LIMITATIONS OF THE POSTAL SERVICE'S INFORMATION SYSTEMS.	28
V.	WITNESSES COHEN AND STRALBERG HAVE PRESENTED AN ALTERNATIVE METHODOLOGY FOR DISTRIBUTING MAIL-PROCESSING COSTS THAT USES BRADLEY'S VOLUME-VARIABILITY RESULTS AND DEGEN'S MODS COSTS POOLS BUT AVOIDS DEGEN'S FAILURE TO DISTRIBUTE MIXED-MAIL AND NOT-HANDLING COSTS ON THE BASIS OF REASONABLE INFERENCES OF COST CAUSATION BY SUBCLASS.	30
	CONCLUSION.....	34

TABLE OF AUTHORITIES

	<u>Page(s)</u>
JUDICIAL OPINIONS	
<u>National Ass'n. of Greeting Card Publishers v. United States Postal Service</u> , 462 U.S. 810, 826 (1993)	26
STATUTES	
Postal Reorganization Act of 1970, Public Law 91-375, 84 Stat. 719, 39 U.S.C. §§ 101, et seq.	2
Section 3622	25, 26, 30
Section 3622(b)(4)	20
Section 3622(b)(8).	20
ADMINISTRATIVE DECISIONS	
Postal Rate Commission Opinions and Recommended Decisions	
PRC Op. R94-1 (Nov. 30, 1994)	14, 15
Postal Rate Commission Orders	
Order No. 1002, Order Terminating Docket No. RM92-1 (January 14, 1994)	13
Order No. 1201 (November 4, 1997)	12
REGULATIONS	
<i>Domestic Mail Manual (DMM)</i> §§ M041.5.2 and M045.4.1	11

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STATEMENT OF POSITION

In this case the Postal Service substantially advances the understanding of postal costs, particularly with respect to the volume-variability of mail-processing costs. It also seeks moderate rate increases. Given recent financial successes beyond those predicted by the Service, the Postal Rate Commission should ensure that the rates it recommends do not exceed those proposed by the Service. Similarly, *whatever the resolution of the mail-processing cost issues addressed by this brief*, the Commission should recommend a cost coverage that results in rates for Periodicals no higher than those proposed by the Postal Service.¹

¹ The Alliance of Nonprofit Mailers (ANM) and the Coalition of Religious Press Associations (CRPA) believe that the Postal Service's rate request should be denied in its

[footnote continues on next page]

Unfortunately, the Postal Service's effort in this case concerning the decade-long problem of excessive and unexplained increases in mail-processing costs for Periodicals, particularly not-handling and mixed-mail costs, is woefully inadequate. This problem has festered so long and is so serious that Periodicals mailers, in an unprecedented action, have united to urge the Commission to address it. The Postal Service continues to pretend the problem does not exist.

This united group of Periodicals mailers presents in the testimony of witnesses Stralberg and Cohen a more methodologically sound, better supported, more accurate approach for distributing mixed-mail and not-handling costs. Stralberg and Cohen offer two alternative ways of implementing their approach of distributing those costs across, rather than within, MODS cost pools.

The Stralberg/Cohen approach permits the Commission to employ the advances in costing methodology proposed by the Postal Service, including Degen's general conceptual approach to distribution, but still to distribute mail-processing costs in a fair and equitable manner as required by the Postal Reorganization Act. Public Law 91-375, 84 Stat. 719, 39 U.S.C. §§ 101 et seq.

SUMMARY OF ARGUMENT

The Postal Service's reported Periodical mail-processing costs continue to increase far more rapidly than anyone has been able to explain. Mailers and the Commission have tried and failed to persuade the Postal Service to address this issue squarely, and only now--too late for use in this case--has the Postal Service agreed to study the Periodicals cost problem in depth. However, nearly simultaneously with the Postal Service's admission of the problem, its witness

entirety because of the revenue requirement issue discussed in those parties' separate briefs. Should the Commission decide to recommend any rate changes for Periodicals in this docket, however, ANM and CRPA support the methodologies advocated in this brief.

Degen suggests incorrectly that his distribution methodology "squarely addresses" mailer concerns (which it could not possibly do, in part because it fails to tackle the problem of rapidly rising "not-handling" costs). He also claims, equally incorrectly, that mailers are themselves to blame for cost increases because, he surmises, they have reduced their use of five-digit pallets. He neither proved this claim, nor made any attempt to quantify its supposed impact, nor did he consider the more than offsetting effects of increased barcoding, dropshipping and presorting that should have led to substantially reduced unit processing costs.

Although publishers remain dismayed that Periodicals reported processing costs continue to increase, they are pleased that, through the testimony of witness Bradley, the Postal Service has at last discarded the arbitrary, grossly improbable assumption that mail-processing costs are essentially 100 percent variable. For the first time, this question has been studied in a rigorous manner with a series of regressions that show that variability by activity ranges from 40 percent to 99 percent, with an average of 76 percent. Bradley's testimony, along with supporting testimony from other witnesses and the responses to Notice of Inquiry No. 4 on Mail Processing Variabilities (January 15, 1998) (NOI 4) provides overwhelming record support for the variabilities used here. Only witnesses Neels and Smith try to undermine this conclusion, but their efforts were thoroughly discredited on rebuttal. This record will not support the continued use of 100 percent variability.

On the other hand, witness Degen's method for distributing attributable processing costs starts with a reasonable premise of distributing volume-variable costs by operating cost pools, but his application is overly mechanistic, blindly applying assumptions that fly in the face of evidence of cost causality. He also commits an important methodological error, resulting from his failure to recognize that the selection of MODS cost pools did not establish or exhaust the possibilities for reliably associating subclasses with costs and his failure to understand that

costs from within cost pools could and often should be moved into other distribution bases without losing their volume-variable character as determined by witness Bradley. In addition, because he mistakenly concluded that the variability calculations required the use of the same cost pools for purposes of distributing costs, even where the subclass associations are unknown and operational realities prove otherwise, Degen refused to subject his assumptions to empirical checks (that undoubtedly would have shown those assumptions to be substantially invalid).

Through the direct and rebuttal testimony of witnesses Stralberg and Cohen, the Periodicals intervenors have proposed modifications to the Degen method that use its appropriate underpinnings, replace its erroneous assumptions with alternative distributions and, importantly, do not break the necessary link between the Bradley and Degen costing approaches. This modification makes use of relevant information that Degen ignores and takes into account important matters that Degen neglects, such as the statutory requirement for reliable evidence of cost causation by subclass, the lack of evidence for distribution of mixed-mail and not-handling costs within cost pools and operational interrelationships.

Perhaps the fundamental difference between the Postal Service and these intervenors is our rejection of Degen's exclusive reliance on the cost pools to distribute the mixed-mail and not-handling costs within each cost pool, based upon the subclass distribution of direct tallies in the same pool. This approach is easy, straightforward, but unfortunately wrong.

Witnesses Stralberg and Cohen, on the other hand, use all available information on cost causality, and they propose two alternatives for dealing with those costs for which no proof of causality exists: either treat them as overhead costs to be distributed in accordance with all other distributed mail-processing costs, or treat them as institutional costs. Their specific proposed cost distribution uses the first of these alternatives.

Properly adjusted cost distributions will produce a significantly higher cost coverage for Periodicals than the 107 percent calculated by the Postal Service, although the Postal Service is correct that there is good reason to substantially moderate that cost coverage. In addition to the 1996 post-reclassification increase suffered by most periodicals and the rapidly escalating costs that have yet to be explained, both of which were relied upon by the Postal Service to support a moderate Periodicals rate increase, the record indicates a likely over-attribution of transportation costs to Periodicals and perceived declines in service quality as well. For all of these reasons, and to reflect the ECSI value of Periodicals, an historically low cost coverage as recommended by the Postal Service is fully justified.

ARGUMENT

I. EXCESSIVE INCREASES IN PERIODICALS MAIL-PROCESSING COSTS REMAIN UNEXPLAINED.

A. Witnesses Little and Crain describe the problem.

In their direct testimony, witnesses Little and Crain describe the severity of the unexplained increases in reported Periodicals mail-processing costs since 1986 and the industry's disappointment that the Postal Service has ignored both our and the Commission's pleas for a meaningful examination of the problem. Witness Little explains that Periodicals' reported mail-processing costs have increased by 71 percent while increases for other classes have been significantly less. Indeed, according to Postal Service data, reported Periodicals costs have increased much more rapidly (71 percent) than Postal Service wage rates (41 percent). Tr. 27/14544, 14547.

B. Witness Cohen discusses the problem's history and the efforts of mailers and the Commission to persuade the Postal Service to address it.

Witness Cohen's direct testimony details the long history of the industry's and the Commission's concerns about these unexplained cost trends and criticisms of the Postal Service's cost-measurement and distribution methodologies. Tr. 26/14029-36. "Despite diligent efforts," Cohen notes, "these trends remain largely unexplained. A problem clearly persists, and the USPS has made no meaningful effort to address it." Tr. 26/14029. She adds:

[t]hese disproportionate increases in mail-processing costs occurred during a period when the USPS increased worksharing incentives (presort, automation, and drop ship discounts) and invested billions in automation. As a result of these incentives, Periodicals mailers today do much of the work previously performed by USPS employees. [*Id.*]

C. The Postal Service knows there is a problem.

The Postal Service, at least for purposes of this case, would prefer the Commission to believe there is no problem with its reported mail-processing costs, but its actions and admissions confirm that it knows otherwise:

- (1) On February 28, 1997, the Postal Service issued a Solicitation for Proposals for a "Data Quality Study" to address, among other things, the "growth in time associated with 'mixed mail,' 'nonproductive,' 'non-handling,' and 'overhead' observations.'" The contractor is required to assess costs and "comment on the USPS's ability to link these costs to classes of mail." Tr. 19B/8823.
- (2) Postal Service witness Moden (USPS-T-4) mentions "a couple of peculiar outputs from the cost models" relating to Periodicals and Standard (A) Nonprofit flats mail-processing which he characterizes as "enigmatic." He states, "we are determined to identify the factors that may have led to these results. *Id.* at 11-12.

- (3) Postal Service witness O'Hara (USPS-T-30) notes that "the proposed cost coverage [for Regular Periodicals] has been further reduced due to consideration of the effect of rate increases (criteria [sic] 4)." According to O'Hara, "the Postal Service is undertaking an analysis to understand what factors may have contributed to increases in flats mail-processing costs, especially for Periodicals." USPS-T-30 at 30. As of October 21, 1997, these analyses were "still in the design phase." Tr. 19B/8820.
- (4) In its rebuttal case, the Postal Service through witness Taufique reaffirms its awareness that the anomalous increases in Periodicals mail-processing costs have yet to be properly studied or explained, and as a consequence its support for moderating Periodicals cost coverage. Taufique testifies:

Periodicals in the recent years have experienced relatively large increases in attributable costs, and the Postal Service is committed to objectively evaluating the cause of the increases. The lower-than-historical cost coverage proposed for Periodicals in this Docket reflects in part the concerns of the Service to avoid major disruptions in the industry. The mechanical approach of using the markup indices from Docket R94-1 proposed by Dr. Henderson will lead to inappropriate increase for Periodical mailers, and I recommend that the Commission reject his approach. Tr. 34/18520 (footnote omitted).

D. Degen's direct testimony asserts that his proposed new cost distribution methodology "squarely addresses" the problem, but in fact he ignores the issues raised by Periodicals mailers and proposes a methodology that would make the problem worse.

Degen, whose job it was to do so, made no effort to inquire into the causes of the anomalous trends in reported Periodicals costs when he was developing his proposed new distribution methodology. Nevertheless, his direct testimony contends that his proposed methodology "squarely addresses" the problem. USPS-T-12 at 8. This is so only if by "squarely addresses" he means: (1) assuming

without investigation that the problem does not lie in the Postal Service's data collection or analysis systems, but in some as-yet-unknown characteristic of Periodicals mail preparation; and (2) designing a new methodology that places even greater reliance on the most questionable data ("mixed-mail" and "not-handling" costs) and has as its central feature a conclusive presumption that the data on these large, rapidly growing, long suspect, increasingly mysterious cost pools accurately and reliably reflect cost-causation by subclass. In fact, Degen did not look into the concerns raised by Periodicals mailers, and his methodology would simply incorporate and then exacerbate the continuing over-allocation of mail-processing costs to Periodicals.

E. Having ignored anomalous cost trends while developing his direct testimony, Degen presents on rebuttal another in the series of last-minute Postal Service "explanations" of the excessive cost increases which, like its ignominious predecessors, explains nothing.

As it did at the ends of Dockets R90-1 and R94-1, when no effective rebuttal was possible, the Postal Service has again in this docket launched a last-minute "explanation" of that decade-long increase.² In the ten weeks between the filing of intervenors' direct testimony and its rebuttal, the Postal Service has developed a new theory, one that it presents not through the testimony of a Postal Service operations witness but through an outside consultant whose attention has obviously

² In R90-1, the "explanation" was a mysterious, never identified, quality of Periodicals flats that, according to witness Hume, caused them to be rejected by flat sorting machines (FSM's) and to require manual sorting. Docket No. R90-1, USPS-RT-7 at 33-34. In R94-1, it was witness Barker's "transfer hub" theory, which blames the increases on the Postal Service's 1984-85 attempt to take Periodicals out of BMC's and process them in less mechanized facilities. Docket No. R94-1, Tr. 25/11708-09.

been focused on other postal matters -- witness Degen (USPS-RT-6).³ And, as in previous cases,⁴ this newest explanation turns out upon examination to be no explanation at all.

Degen takes a two-pronged approach to the problem. First, based on a specious comparison of wages and processing costs, he denies its existence; then, he contends that the problem does exist and that the mailers themselves have caused it by reducing their use of five-digit pallets. Of course, Degen did not bother to quantify the increased cost of mail moving to "less aggregate" pallets (if in fact such movement occurred) (Tr. 36/19416-17), or to examine the several ways in which mailer activity has substantially *decreased* Periodicals processing costs (through finer presort, barcode usage, additional drop shipping, etc.). See Section I.G., *infra*.

Degen's denial of publisher claims that mail-processing costs have outstripped wage costs is easily disposed of. He first suggests, without explanation, that the graphical comparison should be "rebased to be equal in 1989," which produces Figure 3 at Tr. 36, page 19347. Indeed, compared with the 1986-based graph above it, that figure appears to show a congruence of processing costs and wage rates. However, of eight graphs indexed to each year 1986 through 1993,

³ Even as to the theory *du jour*, the claimed decrease in five-digit pallets, Degen states: "I can't say for certainty that that's what's happened." Tr. 36/19420 (*sic*).

⁴ In fact, contrary to Hume, the reject rate on FSM's is minimal today, as it was in 1990. The Postal Service's estimate of Periodicals flat machinability in this docket is higher than ever. According to witness Moden, the various certified poly-wrap materials used by Periodicals mailers cause no problem on FSM's. Tr. 11/5926-27.

The transfer-hub problem occurred in 1984-1985, before the large increase in Periodicals costs, which started after FY86. Common sense dictates that Periodicals costs should have declined rather than increased as the problem was being solved.

only the 1989 index selected by Degen supports his conclusion. Each of the other graphs shows costs substantially outdistancing wages.⁵

Having tried (and failed) to show that there is no problem, Degen then asserts self-contradictorily that the problem exists and is the mailers' own fault, because, he says, they are using fewer five-digit pallets. Although this theory has been presented for the first time in rebuttal testimony, without discovery or surrebuttal, it is not difficult to disprove.⁶ It is apparent that Degen's assertion that in only a few years use of five-digit pallets has dropped precipitously (from 43 percent to 11 percent) is factually baseless. Even if it were true, this baseless theory could not explain the increases in processing costs. Indeed, Degen admits that he made no effort to quantify the effects of his pallet-shift hypothesis. Tr. 36/19416-17.

There is proof in this record that the claim of 43 percent five-digit palletization in 1993 was incorrect. Although there is no equivalent proof that the 11 percent figure is erroneous, strong circumstantial evidence points to such error:⁷ evidence in the data presented by Mr. Little pertaining to *Better Homes and Gardens* (Tr. 27/14611-22); that presented by Time Warner showing significant *and increasing* use of five-digit pallets (Tr. 36/19451); and the missing data that the Postal Service

⁵ See Exhibit ABP-XE-2, Tr. 36/19427. That exhibit and Exhibit ABP-XE-1, appearing at transcript page 19422, have been reversed; XE-2 should be XE-1, and XE-1 should be XE-2. Confusion should be precluded by the context of the cross-examination and the titles of the exhibits.

⁶ Another problem is that a hurriedly concocted theory is prone to error, as illustrated by the Postal Service's filing on March 24 of a correction to Degen's calculation of the level of five-digit palletization in 1993. That answer corrects for the error of including certain three-digit pallets as five-digit pallets, but it fails to address the equally significant error of including so-called "carrier route" pallets as five-digit, which the witness was specifically requested to address. Tr. 36/19435, lines 16-21; see also Tr. 36/19432-33.

⁷ Even Degen would not vouch for its accuracy. Tr. 36/19438.

could have, but did not, present in support of its claim.⁸ Moreover, there are further reasons to doubt the results of Degen's cursory analysis of five-digit palletization: the recent reduction of minimum pallet weight to 250 (from 500) pounds; the requirement that a five-digit pallet be created whenever there are 500 pounds to a five-digit destination (Tr. 36/19447); and the crucial service advantages of using five-digit pallets (Tr. 36/19448).⁹

Given (1) Degen's admission that there is now more drop shipping, deeper presortation, and more barcoding of Periodicals (Tr. 36/19452-53), all of which should have produced a reduction in unit costs,¹⁰ (2) his failure to quantify (even

⁸ Despite Degen's claim that he badly wanted Time Warner palletization data for 1993, the Postal Service declined an offer to have those data introduced into the record. Tr. 36/19440. We recognize that because the information had been assembled only after Degen's new theory was presented, the Postal Service did not have the opportunity to determine how the facts fit with its theory, but a public agency should be willing to accept those facts whatever they show.

⁹ See *Domestic Mail Manual (DMM)* §§ M041.5.2 and M045.4.1.

¹⁰ The number of regular rate Periodicals flats qualifying for pre-barcode discounts grew from zero in FY92 to 930 million in FY93 to 1,713 million in FY96, when total pre-barcode discounts were \$47.713 million. Even larger savings should have resulted from sharply increased levels of Periodicals presortation. From FY89 to FY96 the percent of regular rate Periodicals entered in carrier route presorted packages increased from 26.21 percent to 39.34 percent, and the percent entered as Level A, the lowest presort level, declined from 27.16 to 19.32. See the billing determinants for FY89 (Docket No. R90-1, WP. I.F., UPS-T-18 [Lyons]), FY92, FY93 (Docket No. R94-1, WP. 1.D., USPS-T-11 (Foster), and FY96 (USPS LR H-145). This major increase in presortation has required large investments by mailers and their printers in advanced binding equipment. See, for example, response of Time Warner Inc. to USPS-TW-35c. (Tr. 31/16840).

Degen focused instead on a supposed reduction in 5-digit pallet use since FY93, which he associated with a supposed decline in the number of pieces per package. With regard to the latter claim, the two studies on which Degen relied (LR MCR-4 from Docket No. MC95-2 and LR H-190 from this docket) showed that palletizing mailers actually increased their number of pieces per package.

Degen argued that there might be some problems with flats automation and that maybe not all pre-barcode flats are machine sorted. Tr. 36/1941.5 But the fact that even barcode flats are sometimes sorted manually is already accounted for in the worksharing models

[footnote continues on next page]

conjecturally) the effects of a shift to less aggregated pallets, and (3) the doubt that such a shift even occurred, the only conclusion possible is that the supposedly rapidly increasing costs of processing Periodicals are no better explained now than when this case began.

F. The record contains no explanation of the tremendous growth in not-handling costs, although these costs play a crucial role in determining attributable costs.

Unfortunately, only the Postal Service is in a position to explain the disproportionate increases in Periodicals mail-processing costs. As the Commission has observed in this docket, the "Postal Service is subject to broad and somewhat unique obligations when it files a rate Request." PRC Order No. 1201 (November 4, 1997) at 12.

These obligations exist both because the Postal Service is the proponent of changes in rates, and because the Service is the repository for the vast majority of data relevant to rate case issues. Not only the Postal Service, but also the parties and the Commission, have to use and rely on information collected in Postal Service data systems and developed by Postal Service employees and consultants. Neither the participants nor the Commission has access to the Postal Service for the purpose of performing studies or collecting data. [*Id.*]

If the Postal Service chooses not to address a problem, that problem will not -- indeed usually cannot -- be addressed. Yet facts do not cease to exist because they are ignored.

Certainly nothing has changed since the Commission noted, in terminating its 1992 inquiry into the anomalous increases in mail-processing costs:

used to compute automation savings, presented by Byrne in MC95-1 and Seckar in this docket. See USPS-T-26 at 26-27 (Seckar).

The Postal Service has not acknowledged the importance of the issues involved and there is very little evidence that the Postal Service takes these issues seriously. . . . The Postal Service is avoiding accountability and sullyng its own interests by pretending that the problem does not exist.

Order Terminating Docket No. RM92-2 (Order No. 1002 [January 14, 1994]) at 3-4.

It is time to hold the Postal Service accountable for its failure either to explain the so far unexplained increases in reported mail-processing costs, or to design a costing methodology that reports, attributes, and distributes mail-processing costs accurately.

The record in this case leaves no doubt that there has been a very large increase in mail-processing-related not-handling, i.e., time spent by clerks and mailhandlers not-handling mail. Yet the Postal Service, and particularly witnesses Degen and Steele, steadfastly insist that *virtually all this not-handling time is devoted to productive work and that rising not-handling costs are not a problem.* Tr. 33/17850-54; Tr. 36/19340. Observations recorded by IOCS clerks and translated into various activity codes, however, provide considerable information about the nature of not-handling activities, and tell another story. In some cases, clerks and mailhandlers were engaged in specific activities (such as window service or administrative work), or activities related to specific subclasses and services (Express Mail, Registry, etc.). Such costs can be attributed precisely if one uses this IOCS information, which witness Degen, for reasons still not explained, refuses to do.

However, most not-handling costs, where almost all the increase has occurred, consist of the following categories (IOCS activity codes in parentheses):

- (1) breaks/personal needs (6521);
- (2) clocking in and out (6522);
- (3) empty equipment (6523);

- (4) shape-related not-handling (5610, 5620, 5700, used when employees are at operations that process only one shape of mail: letters, flats, or parcels); and
- (5) mixed all-shapes not-handling (5750).

The first three of these have in the past been referred to collectively as "overhead" costs. Tr. 26/13849. As a percentage of all other mail-processing costs, these overhead costs have grown from 14.2 percent in FY80 (the first year from which comparable records are available) to 23 percent in FY89, and to 31.5 percent in FY96. Tr. 26/13841; PRC Op. R94-1 para. 3023 (Table III-1). Degen's rebuttal testimony, which purports to show that not-handling costs have not really grown much, and so are not a problem, fails even to mention this very large and still growing category of costs.

Degen attempts to show that other not-handling costs are spent on useful work by listing various legitimate activities that can give rise to such costs. But the examples he cites are either insignificant (e.g., walking to another machine when the machine a clerk was working on is being repaired, which presumably happens only occasionally and not at manual operations), or they were no less necessary in FY86 than in FY96 (e.g., moving containers, turning to the belt to pick up another piece). Why then have not-handling costs for these activities increased so much?¹¹

¹¹ Degen argues that shape-related and mixed-all-shapes not-handling costs really have not grown, because in FY92 IOCS data collectors were told not to tell sampled employees to pick up mail if they were not already holding mail in their hands. But Degen does not know whether or to what extent data collectors previously told employees to pick up mail -- and there had never been an instruction that they do so -- and he does not know, or have any opinion about, how large an effect the change in instructions had, if any. Furthermore, Degen's table of increasing not-handling costs (Tr. 36/19344) shows no particularly large increase in FY92 when the IOCS change occurred.

The only plausible Postal Service explanation of increased not-handling costs is witness Barker's comment in R94-1 that in an automated environment employees may spend relatively more of their time tending machines instead of handling mail. That might explain not-handling costs incurred at BCSs and OCRs. PRC Op. R94-1 para. 3014. However, as Stralberg points out, even most of the letter-specific not-handling costs are recorded at manual operations. These same operations apparently got along fine without all those not-handling costs in the pre-automation environment.¹²

Far from explaining the increasing not-handling costs, Degen addresses them inconsistently and, in the end, incoherently. His claim in direct testimony to have "squarely addressed" concerns about increasing not-handling costs (USPS-T-12 at 5) makes no more sense than does his claim on rebuttal that the costs have *not* grown (Tr. 36/19382) or his baffling statement that his method "effectively ignores" the not-handling costs that he in fact distributes in more detail and at a finer level of disaggregation than has been done (or proposed) before (*id.*); or his similarly incomprehensible comment on oral cross-examination that he "did not need" the not-handling costs because he used MODS to determine the size of cost pools (Tr. 36/19388); or his argument that Stralberg's and Cohen's detailed treatment of these costs, by virtue of paying attention to what IOCS clerks have recorded about them, is too "complicated" (Tr. 36/193234); or his repeated invocation of Bradley's testimony to disprove the existence of cross-pool cost relationships that Bradley explicitly recognized in his analysis (Tr. 36/19386).

In fact, all that Degen has shown, because it is all he is interested in, is which cost pools employees are clocked into when they don't handle mail. That is not the same as determining the true cause of these costs. The record in this docket shows

¹² See Tr. 26/13884, 13960.

the existence of a variety of other causes: employees coming to work or returning from lunch have strong incentives to clock immediately into some pool, even if not the one they are working in, since they will not be paid for their time until they have clocked in. Tr. 12/6213; 36/19401. Moreover, as the Postal Inspectors observed, employees often clock into opening units until given assignments elsewhere. USPS-LR-H-236, National Coordination Audit Allied Workhours at 19. Additionally, as Bradley recognized but Degen stubbornly denies, employees often perform activities, particularly at allied operations, that directly serve other operations. USPS-T-14 at 18. In any event, no matter what the employee is doing, both MODS and IOCS are inherently incapable of explaining *why* an employee is in a certain place at a certain time *not-handling* mail. Tr. 26/13966-67.

There is only one candid answer to the question of why not-handling costs have increased so much: the Postal Service still has not discovered how to make effective use of its employees in an automated environment.¹³ Simplistic “solutions” to the not-handling problem such as Degen’s pool-by-pool approach do nothing more than enable postal managers to pretend, or even believe, that the problem does not exist, thus relieving managers all along the chain of command from having to think about how to solve it. Such “solutions” also relieve the analyst from having to deal with the inconvenient and intractable fact that, as Stralberg and Cohen realized, there simply is no fully satisfactory way to distribute these costs based on available data, that the task assigned is the drawing of sufficient conclusions from insufficient premises, and that the best one can do at this time is

¹³ Outside the rate case setting, the Postal Service appears finally to have recognized that it has a problem. The just-released 1997 Comprehensive Statement on Postal Operations, for example, states (at 67) that “[m]any current staffing authorizations are outgrowths of organizations that no longer exist” and describes various steps, including development of new computer models, that the Postal Service is now taking to try to bring its workforce more into conformity with actual workloads.

to treat these costs, particularly break time and mixed-all-shapes costs, either as institutional costs or as overhead costs that must be shared by all mail.

- G. Periodicals mailers have made significant efforts to reduce costs, including increased palletization of mail. We support the 3-digit discount which would recognize, in part, those efforts, and we support the moderation recommended by the Postal Service in further Periodicals rate increases.**

As striking as the Postal Service's failure to establish (through the rebuttal testimony of witness Degen) that changes in palletization practices help explain the seemingly out-of-control Periodicals processing costs (which its witness O'Hara testified a few months earlier could not be explained)¹⁴ is its failure even to examine more obvious and more quantifiable changes that should have led to reduced unit costs.

A parade of witnesses explained that increased preparation by Periodicals mailers has reduced the workload of the Postal Service. Witness Crain (Tr. 28/15281) testified that his company is spending increasing amounts of money to prepare and drop ship its mail. Tr. 15/15302-03, 15331. Witness Little testified that his company, Meredith, has increased drop shipping and barcoding and has been able to increase its use and weight of pallets dramatically. Tr. 27/14660-61. He noted that this experience is part of an industry-wide phenomenon, because periodical mailers now "prepare their mail more efficiently than ever before, through increased levels of presortation, palletization and drop shipping." Tr. 27/14547.

¹⁴ USPS-T-30 at 30-31.

Witness Hehir confirmed that the industry, and McGraw-Hill in particular, have had the same experience. Tr. 27/14710-11.¹⁵

Even Postal Service witness Degen, who speculated that a decrease in five-digit palletization can be blamed for increasing Periodicals mail-processing costs, acknowledged that publishers significantly increased their barcoding, drop shipping, and depth of presort between 1989 and 1996. Tr. 36/19410, 19413, 19453. Most significantly, Degen candidly admitted:

Mail preparation has a substantial impact on costs. Increases in presortation, drop shipping or mail piece readability can all have substantial impact on the observed trend in aggregate unit costs. [Tr. 36/19352.]

Exactly.

Moreover, *precisely because these mailer activities reduce postal costs, the array of discounts offered by the Postal Service should, as requested in the filing, be enlarged through the creation of a new three-digit sortation discount.* Proposed by Postal Service witness Taufique as resulting in a fair and equitable recognition of postal costs, the three-digit presort discount will partially offset the increases felt by smaller circulation periodicals following the Docket No. MC95-1 reclassification case. As explained by ABP witness Cavnar (Tr. 28/15344), the proposal "will better conform rates to how USPS now handles all three-digit packages, and eliminates obsolete distinctions between different three-digit make-up schemes." This unopposed proposal should be recommended.

Also counseling moderation in rate increases for Periodicals are uncertainties about the methodology by which the Postal Service attributes sharp

¹⁵ The testimony by the publisher witnesses was confirmed by technical witnesses Cohen (Tr. 26/14029-30) and Stralberg (Tr. 26/13821: "New technology and increased mailer presorting, barcoding and palletization... should have made the Postal Service's job easier.")

increases in purchased highway transportation costs to Periodicals. As argued by McGraw-Hill witness Hehir (Tr. 27/14712-13), the questionable allocation of purchased highway transportation costs to Periodicals is an additional reason for limiting Periodicals rate increases in this case to those proposed by the Postal Service. The Postal Service proposes to attribute some \$180 million of such costs to Periodicals Regular mail for the test year 1998, as compared with about \$137.7 million in 1995. Tr. 13/7189. The Postal Service acknowledges that the extent of this increase is unusual, but is unable to provide any satisfactory explanation, other than that it may reflect an anomalous "variation in the statistical estimates." Tr. 19/8744.

In view of the unusual and as yet unexplained increase in the amount of these costs, the uncertainty about the Postal Service's methodology for classifying them provides an additional reason why the Commission should not go beyond the modest Periodicals Regular rate increase proposed by the Postal Service.

The cumulative impact of the rate increases proposed in this case and those implementing the Docket No. MC95-1 Reclassification decision less than two years ago is yet an additional reason for moderation in setting the Periodicals cost coverage. Witness O'Hara (USPS-T-30), the Postal Service's pricing witness, recognizes the impact on some publishers of the significant rate changes approved in Docket No. MC95-1, especially "smaller publications with geographically dispersed circulation." *Id.* at 31.

For tabloid publications, which comprise about 19 percent of magazine volume (Tr. 28/15351), implementation of reclassification in July 1996 brought higher-than-average increases, including a 10.4 percent increase in the 3/5 digit Periodicals regular-rate non-automation per-piece rate and a 3.5 percent increase in the basic per-piece non-automation rate. Tr. 28/15337. Publishers like Crain Communications, which specializes in national smaller-circulation professional

publications, many of which are tabloids, experienced overall increases of 5.5 percent over prior rates, despite Crain's extensive use of drop shipping. Tr. 28/15282, 15305.

Many other publications experienced similar increases as a consequence of reclassification. Tr. 27/14707; 28/15339. As recognized by witness O'Hara, these recent rate increases weigh in favor of only moderate increases in Periodicals rate increases in this case, pursuant to 39 U.S.C. § 3622(b)(4) ("effect of increases on . . . mail users") and (b)(8) ("the educational, cultural, scientific, and informational value to the recipient of mail matter").

II. THE TRADITIONAL PRESUMPTION THAT MAIL-PROCESSING COSTS ARE ALMOST TOTALLY VOLUME-VARIABLE HAS BEEN SUBJECTED TO EMPIRICAL INVESTIGATION AND HAS BEEN DISPROVED.

There is no longer any doubt that the cost elasticity of mail-processing is substantially less than one, or that, on this record, the range of cost elasticities for mail-processing that can be regarded as reasonable and supported by substantial evidence is limited. Postal Service witness Bradley's estimated variabilities represent the upper bound of that range.

A. There is no substantial evidence – on this or any other record – supporting the supposition that mail-processing costs are almost totally volume-variable.

Most regression models estimated on this record result in volume-variabilities that are substantially less than 100 percent. The only exceptions are models that have been strongly rejected by statistical hypothesis tests of validity. Witness Bradley's estimates result in variabilities ranging from a low of 40 percent for Manual Parcels activities at MODS facilities to a high of 99 percent for Mechanized Sack Sorting at BMCs. USPS-T-14 at 54, 63, 65, 67. The system-wide average

volume variability implied by witness Bradley's fixed effects estimates is 76 percent. USPS-T-12 at 15; Tr. 29/16126.

Several alternatives to witness Bradley's volume-variability estimates have been reported in this proceeding from several competing models – notably the pooled model, the “between” model, and the unrestricted model that allows all parameters to vary by facility. Also available on this record are the results of the statistical tests reported in the responses of MPA (MPA-NOI-1), UPS (UPS-ST-1), and the Postal Service (USPS-ST-55) to the Rate Commission's Notice of Inquiry No. 4 on Mail-processing Variability. These test results, together with the results of other tests reported by witness Bradley in his direct testimony, provide the framework for evaluating the alternative variability estimates.

Three *F* tests were performed in response to NOI No. 4: a test comparing witness Bradley's fixed effects model to an unrestricted model in which all parameters are allowed to vary across facilities (“Test 1”); a test comparing a pooled model, in which all parameters are restricted to being identical across all facilities, to the unrestricted model (“Test 2”); and a test comparing the pooled model to the fixed effects model (“Test 3”).¹⁶ The results of these three tests are summarized in the following table.

¹⁶ MPA reported results for Test 1 and Test 2 for all of the MODS direct mail-processing operations. UPS reported results for Test 2 for the same set of operations. The Postal Service reported results for Test 1, Test 2, and Test 3 for four mail processing operations.

Results of *F* Tests Reported in NOI No. 4 Responses

Test	Result of Test
Test 1	Reject models with identical slope and intercept parameters across sites in favor of model that allows all parameters to vary by site.
Test 2	Conditional on separate intercepts by site, reject models with identical slope parameters across sites in favor of model that allows slopes and intercepts to vary by site.
Test 3	Conditional on common slopes across sites, reject models with common intercept parameters across sites in favor of model that permits separate intercepts by site.

Notice of Inquiry No. 4 established what Bradley's methodology quantifies -- that the cost elasticity of mail-processing is substantially less than one. There is no substantial evidence on this record supporting any model of volume variability other than (1) Bradley's or (2) the unrestricted model, which shows variabilities even lower than Bradley's.

From a purely statistical standpoint, only one model in this proceeding is left standing at the end of this exercise: the unrestricted model that permits all parameters -- both the intercept and the vector of slope coefficients -- to differ across mail-processing facilities. Tr. 29/16122-27, Tr. 28/15779. Only this model can claim to provide *unbiased* estimates of the volume variability of mail-processing costs within cost pools. Tr. 29/16144. All estimators that impose demonstrably incorrect restrictions produce variability estimates that are presumptively biased. *Id.* The degree of bias depends on *how* wrong the restrictions are. *Id.* The alternative models -- the fixed effects model, the pooled model, and, by extension, the "between" model -- are listed in increasing order of restrictiveness, they are therefore also increasingly biased.

The unrestricted model does not provide a single, average variability for each cost pool; instead, it results in a distribution of variabilities – *i.e.*, one estimate per facility in the data set. Tr. 29/16126. In order to obtain an unbiased estimator of the national average variability for each cost pool, it is therefore necessary to take the sample mean, weighted by the total piece-handlings at each site in that cost pool.¹⁷ In most cases, the weighted mean variability obtained from the unrestricted model is somewhat lower than that provided by witness Bradley's fixed effects model. For instance, the fixed effect estimate of variability for the OCR cost pool is 79 percent, while the unrestricted model yields an estimate of 74 percent. For Manual Letters the corresponding figures are 80 percent versus 46 percent; for Manual Flats, 87 percent versus 49 percent; and for LSM, 91 percent versus 81 percent.¹⁸ This implies that the direction of bias that results from restricting parameters to be identical across sites is upward.

This insight is confirmed when the unbiased estimates from the unrestricted model are compared with those of the most highly restrictive models on this record: the pooled and "between" models. (Note that these models impose not one rejected restriction but two: they force all intercept terms to be identical across sites, not just the vector of slope parameters.) For example, the variability estimates provided by the "between" model for the Manual Letters, Manual Flats, OCR, and LSM cost

¹⁷ This is the maximum likelihood estimator of the national average variabilities. Tr. 29/16127. Table 3 on page 6 of MPA's Response to Notice of Inquiry No. 4 (*Id.*) lists the weighted and unweighted mean variabilities obtained from the unrestricted model for all of the MODS direct mail-processing cost pools.

¹⁸ The unrestricted estimate of variability is not always lower than the fixed effects estimate: for the SPBS Nonpriority cost pool, the unrestricted model yields a variability estimate of 47 percent, essentially the same as that provided by Bradley's model.

pools are, respectively, 45, 44, 42, and 30 percentage points higher than those provided by the fixed effects model.

Thus, witness Bradley's fixed effects estimates of cost pool volume variabilities provide an upper bound on what is econometrically reasonable in this case. While this estimator is indubitably biased upward to the extent that it imposes a restriction (i.e., common slopes) that is not supported by the data, it nonetheless is the least restrictive model on this record consistent with the goal of obtaining single, national variability estimates for each cost pool.

On the other hand, bias is not the only consideration. Witness Bradley made the point that his model has the advantage of being the least restrictive model *capable of providing a system-wide average variability estimate for each cost pool without requiring additional averaging of variabilities across sites.* Tr. 28/16083-84.

B. Witness Bradley's production of substantial evidence that volume-variability is well below 100 percent shifts the burden of proof to those who would reject his conclusions.

The traditionally used variability of 100 percent for mail-processing costs emerged not from any evaluation of evidence about variability but simply from the need to use some figure in order to calculate rates. The 100 percent figure used by the Postal Service and the Commission, in other words, has always had the character rather of a presumption made necessary by the lack of evidence than of a probabilistic estimation of actual variability. In this respect, witness Degen was right when he testified that the traditional 100 percent variability figure was no more than "a convenience" used because "they [the Postal Service] didn't have any evidence to the contrary." Tr. 36/19399-400.

Consequently, now that witness Bradley has provided substantial, highly credible evidence of what the actual variabilities are likely to be, the 100 percent presumption can have no continuing significance and should be given no further

weight in the Commission's deliberations. To meet their burden of proof, opponents of Bradley's conclusions must be able to point to substantial record evidence that would enable a reasonable decisionmaker to reject Bradley's econometric analysis in favor of some alternative. No such evidence exists on the record of this case.

III. WITNESS DEGEN'S PROPOSED METHOD FOR DISTRIBUTING MAIL-PROCESSING COSTS WITHIN MODS COST POOLS, WHICH IS PARTIALLY AND INCORRECTLY EMBRACED BY WITNESS SELICK, IS INDEFENSIBLE IF DIVORCED FROM BRADLEY'S ESTIMATED MAIL-PROCESSING COST VARIABILITIES.

One party in this case, United Parcel Service, has advocated adopting Degen's method for distributing mail-processing costs within cost pools while at the same time rejecting Bradley's variability analysis.¹⁹ Witness Sellick, without the benefit of analysis or operational experience, enthusiastically endorses the Degen distributions, disregarding their incompatibility with the assumption of 100 percent variability endorsed by witness Neels and indeed by himself. Tr. 36/19222-23, 19225, 19230. In fact, as witnesses Cohen, Stralberg, and Christensen have all pointed out in rebuttal testimony, distributing mail-processing costs within cost pools based on an assumption of 100 percent variability of those costs makes no sense -- either in economics or in postal ratemaking under 39 U.S.C. § 3622. Christensen points out what is axiomatic in postal ratemaking, as in economics generally: "the analytical framework of the variability analysis and the cost distribution method cannot be separated and still be expected to produce economically meaningful

¹⁹ Although OCA appears to take a similar position, it has neither offered a witness in support of the Degen methodology nor put forth a theory as to why this approach makes economic sense. OCA Trial Brief at 25-33.

results." Tr. 34/18221.²⁰ The essential point here is that *the cost distribution system needs to be consistent with the variability estimate.*

Sellick fails to comprehend that when Degen links his distribution of costs with mail-processing operations, he does so on the basis of an inference about causation, an inference Degen gets from Bradley's analysis of mail-processing cost variabilities.²¹ Sellick's assumption that a set of costs can be linked with an operation in the absence of such an inference of causation demonstrates his fundamental ignorance of the theory and methodology of postal ratemaking and rate regulation generally, and of what Degen understood himself to be doing. His assumption is at odds not only with the basic structure of Degen's analysis, but also with Bradley's analysis of causality (the only analysis of causality available to Sellick [see Tr. 36/19284], and with Panzar's even more basic analysis of the economics of pricing under regulation²² (which provides the requirement of a causal nexus between costs and prices that is the foundation of § 3622 [*National Association of Greeting Card Publishers v. United States Postal Service*, 462 U.S. 810, 826 (1983) ("NAGCP IV")] and which is accepted as a fundamental principle by other expert witnesses such as Stralberg, Cohen, and Shew).

Moreover, while witness Degen designated the cost pools, *the cost drivers were identified by witness Bradley.* In accepting witness Neels's rejection of Bradley, Sellick also rejects Bradley's cost drivers, leaving him without a foundation

²⁰ Christensen agrees that in the case of mail-processing operations the "theoretically appropriate distribution key" is the "subclass distribution of the recorded TPH." *Id.*

²¹ See Tr. 36/19381, 193855; USPS-T-14 at 5-6 and Tr. 33/17889; and Tr. 34/18221-23.

²² USPS-T-11 at 5-7; Tr. 34/18446-47.

for his distribution. Tr. 36/19224.²³ Sellick does not grasp that the cost relationships within MODS cost pools that he advocates using as a basis for distribution have no significance for that purpose unless they are *causal* relationships. Degen, based on Bradley's analysis, concluded that they *are* causal relationships. Tr. 36/19385-86. Only Sellick believes it possible to take a position on what cost distribution is proper without grounding it in a theory of cost causation. In light of that belief, the Commission cannot give his evidence on this issue any weight. In his rebuttal hearing, astonishingly, he said that he does *not claim* a causal relationship Tr. 36/19499.

Sellick also does not appear to understand that the differing variabilities between distribution and allied operations are fundamental to Degen's approach. See Tr. 36/19225. This differing variability takes into account the support nature of allied operations and their interrelationships. Thus, although Sellick claims to adopt Degen's methodology, he in fact distorts Degen's implementation of operational relationships and places a disproportionate emphasis on the allied operations in the distribution of mail-processing. *Id.*²⁴

²³ In fact, in at least one case, both Degen and Sellick ignore Bradley's cost drivers. For allied operations, the Degen-Sellick approach is contradicted by Bradley. Witness Stralberg illustrates this very well in his rebuttal testimony. Tr. 36/19282-19284.

²⁴ During the cross-examination on his rebuttal testimony Sellick had an opportunity to defend his approach, but his defense, to the extent one can understand it, offered nothing new. Tr. 36/19501.

Q: Is it your position that you can implement the Degen approach if all cost pools are assumed to have the same variability?

A: The-my position is that you can use the approach I have taken, and that is taking costs using Degen's approach with the previous Commission assumptions of volume variability. I only state - restate that slightly, in that although the cost pools for purposes of running the SAS programs are returned to 100-percent variability, implicitly some of them are not, because they are treated as fixed mail-

[footnote continues on next page]

In the final analysis, whatever the Commission decides about the variability of mail-processing costs and the Bradley study, there is no justification for employing inappropriate and misaligned cost distributions that are not causally related to their host.

IV. DEGEN'S BASIC APPROACH -- DISTRIBUTION OF VOLUME-VARIABLE COSTS BY OPERATIONAL COST POOLS -- IS CORRECT, BUT HIS OVERLY RIGID AND MECHANICAL APPLICATION OF IT FAILS TO ALLOW FOR THE COMPLEX INTERRELATIONSHIPS AMONG MAIL-PROCESSING OPERATIONS OR FOR THE LIMITATIONS OF THE POSTAL SERVICE'S INFORMATION SYSTEMS.

Much information has been introduced in this docket that could provide new insight into how mail-processing costs are incurred. Bradley has estimated volume variability in various cost pools, and Degen has provided additional information, based on the Postal Service's pay data system, about the costs accrued in each of these pools.

We agree that this new information should be used. We also agree that the distinction between costs incurred in MODS offices, BMCs, and NonMODS offices is a useful starting point for distribution of those costs to subclasses, and that for the roughly 50 percent of IOCS tallies that specify a subclass or special service, the volume-variable portion of the associated costs should be attributed to that subclass or service. And we agree that the distinction between (1) not-handling; (2) mixed-mail; and (3) empty container/item costs that has emerged in this docket provides improved conceptual clarity for further analysis of these costs.

processing and so on as discussed in some of my workpapers. But yet, I do believe that Mr. Degen's approach can be used as I have used it.

In concluding, however, that Bradley's analysis requires that costs be distributed exclusively within MODS cost pools, Degen made several errors that have important consequences for his specific distributions: (1) failure to recognize that the use of MODS cost pools and total piece handlings does not in and of itself establish or exhaust the possibilities for reliably associating subclasses with costs; (2) failure to understand that costs from within MODS cost pools could be moved into other distribution bases without losing their volume-variable character as determined by Bradley; and (3) failure to take operational reality into account.

Degen apparently concluded that, by using Bradley's volume-variabilities and confining his distributions to the same cost pools used by Bradley, he would achieve a correct distribution of costs by subclass. Given the fact that the majority of costs distributed are either mixed-mail or not-handling costs, i.e. costs not associated with a particular subclass by MODS or the IOCS, Degen's conclusion cannot be empirically tested or, consequently, empirically justified with the information he employs. Cohen and Stralberg, in their direct testimony, describe numerous problems with simply assuming that the make-up of mixed mail is the same as that of direct mail at any particular operation.

Stralberg and Cohen, on the other hand, recognize what Degen did not: that on completion of Bradley's variability analysis, the appropriateness of using the same pools for distribution purposes remained an open question subject to empirical examination. Tr. 26/13824-25, 14050. Cohen and Stralberg further recognize that consistency with operational reality and Bradley's attribution methodology requires that the Commission make at least two major changes to Degen's distribution procedures.

First, there is strong evidence on the record that allied activities are support operations. As Cohen points out, both Bradley and Moden recognize the support nature of allied operations, with Bradley using the supported operations piece

handlings as cost drivers for the allied operations. Tr. 36/19226-27. This demands that allied mixed-mail and not-handling costs be distributed across all MODS cost pools.

Second, there are also well-documented linkages between different types of mail-processing operations. As Cohen points out, “[w]itness Moden . . . recognized the interactions between manual, mechanized, and automated operations. . .” Tr. 36/19228 (citing USPS-T-4 at 4-5, 21). Bradley also recognized this interrelationship by incorporating the manual ratio in his variability equation. Stralberg and Cohen take this into account. Degen does not.

V. WITNESSES COHEN AND STRALBERG HAVE PRESENTED AN ALTERNATIVE METHODOLOGY FOR DISTRIBUTING MAIL-PROCESSING COSTS THAT USES BRADLEY'S VOLUME-VARIABILITY RESULTS AND DEGEN'S MODS COSTS POOLS BUT AVOIDS DEGEN'S FAILURE TO DISTRIBUTE MIXED-MAIL AND NOT-HANDLING COSTS ON THE BASIS OF REASONABLE INFERENCES OF COST CAUSATION BY SUBCLASS.

Stralberg's and Cohen's proposals permit the Commission to use the advances in costing methodology proposed by the Postal Service, including Degen's basic approach (i.e., distributing volume-variable costs where possible within the same operational cost pools used in calculating the variabilities). Additionally, their proposed method of cost distribution makes use of much relevant information that Degen ignores, rejects Degen's unverified and erroneous assumptions, and takes full account of the following important matters:

1. the statutory test of acceptable cost attribution for postal ratemaking under 39 U.S.C. § 3622 is reliable evidence of cost causation by subclass;
2. considerable evidence (such as cross-pool cost-causal relationships and the unknown proportionalities of cost types within pools -- as adduced by Stralberg and Cohen) shows that

distribution of mixed-mail and not-handling costs exclusively within MODS pools does not reflect subclass cost causality; and

3. the distortions created by strictly adhering to the MODS cost pools can in some cases be removed or alleviated by distributing costs within more broadly defined operational pools, as recommended by Stralberg and Cohen (e.g., distribution of shape-specific mixed-mail and not-handling costs by shape and within CAG and Basic Function).

Our fundamental disagreement with the Postal Service, and in particular with witness Degen, relates to what inferences about subclass causality, if any, can reliably be drawn from the available data. Degen relies exclusively on the cost pools into which employees were clocked to distribute the mixed-mail and not-handling costs within each pool, based on the subclass distribution from direct tallies in the same pool.

This approach may seem intuitively appealing, but Degen carries it too far by ignoring all information recorded by IOCS clerks about where the sampled employees were and what they were actually doing. Even in the most obvious cases, as when an employee was seen selling stamps at a postal window while clocked into a mail-processing operation, Degen rejects the obvious solution (i.e., distributing these costs based on available data on stamp usage by various subclasses) in favor of strict reliance on the cost pool the employee was clocked into. As discussed in the previous section, Degen is mistaken in believing that this approach is somehow required in order to be consistent with Bradley's variability analysis.

The alternative approach presented by Stralberg and Cohen is more careful in evaluating evidence, more circumspect about making assumptions, and more believable in its outcomes. Although they use much information that Degen ignores, Stralberg and Cohen realize that the available data are insufficient to establish

causality between *all* volume-variable costs and specific subclasses with any reliability. In particular, when he puts today's very high not-handling costs in a historical context, Stralberg concludes: (1) that the rise in these costs coincided with the introduction of letter-mail automation and must be at least in part caused by this automation; but (2) the current data are simply inadequate to associate these increased costs directly with specific subclasses.

Stralberg's and Cohen's approach is to use all available information from which reliable inferences of cost causality can be drawn. For costs about which no such inferences can be drawn, Stralberg and Cohen describe two alternatives, each of which is consistent with the principle that associations of subclasses with costs for attribution purposes should be pushed only as far as the evidence warrants:

- (1) distribute these costs upon all other distributed mail-processing costs; or
- (2) treat them as institutional until more reliable information about their true causality becomes available.

The distribution presented by Stralberg and Cohen is based on the first approach. In fact, Stralberg and Cohen attribute exactly the same total pool of volume-variable costs as Degen does.²⁵

There are obviously many ways to partition mail-processing costs in order to distribute them to subclasses. Stralberg and Cohen show that Degen's strict dependence on a pool-by-pool approach to distribute mixed-mail and not-handling costs was: (1) unnecessary in order to maintain consistency with Bradley's volume-

²⁵ The fact that Stralberg, and Cohen with a slightly different approach, present these two mutually exclusive alternatives for the Commission's consideration was seized upon by Degen to accuse them, preposterously, of "double counting." Tr. 36/19340.

variability analysis; and (2) erroneous in that it ignores demonstrable cross-pool cost relationships recognized by Bradley and Moden.

Cohen's and Stralberg's approach, unlike Degen's, is consistent both with *operational reality* and *Bradley's variability framework*. They address the support nature of allied operations cost problem by distributing mixed-mail and not-handling costs in the allied operations across all cost pools. They address the linkage of distribution operations by using the shape-specific not-handling cost information that Degen ignores.

Witness Cohen's rebuttal testimony demonstrates that ignoring the support nature of allied operations causes severe distortions in the costs for Periodicals, Priority Mail and Parcel Post. The costs for these classes could be wrong by as much as 40 to 50 percent if allied costs are distributed incorrectly. This is because a very large portion of total mixed-mail and not-handling costs is in the allied operations. See Tr. 36/19228-30. Similarly, Stralberg shows that almost \$700 million in not-handling and mixed-mail costs at allied operations are incurred moving mail to and from letter, flat and parcel sorting operations. Since most of these costs are letter-related, while the "direct" costs at allied operations are roughly the same for letters and flats, it follows that Degen's results would have been far different had he used this information.

While Stralberg's and Cohen's approach is not perfect, as they readily admit, and can be improved as more data become available, it is by far the best approach presented to the Commission in this docket. It is also, Degen's frequent invocation of Bradley notwithstanding, the approach most consistent with Bradley's analysis -- since unlike Degen, Stralberg and Cohen recognize the strong cross-pool cost relationships described by both Bradley and Moden.

For all of the above reasons, the Commission should adopt Stralberg's and Cohen's method, or a similar method, for the purpose of distributing mail-processing costs in this docket.

CONCLUSION

It is time to hold the Postal Service accountable for its failure either to explain the so far unexplained increases in reported mail-processing costs, or to *design a costing methodology that reports, attributes, and distributes mail-processing costs accurately.*

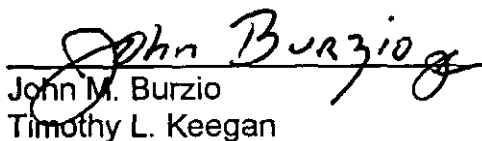
Notwithstanding the modest increases proposed, this is a landmark case the outcome of which is likely to cast a large shadow on future cases, especially if the Commission adapts new approaches to cost attribution and distribution. It is essential, therefore, that the Commission contemplate the future implications of its decisions and subject its prior determinations to enhanced scrutiny before deciding what application they should have here. When it does so, we are convinced that it will recognize that Bradley's variabilities combined with the Stralberg/Cohen distributions represent the best, and the only valid, method for attributing costs to subclasses and that, whatever it decides in this regard, it will recognize the unreliability of the claimed mail-processing costs and recommend Periodical rates no higher than those requested by the Postal Service.

Respectfully submitted,


Dr. John Stapert

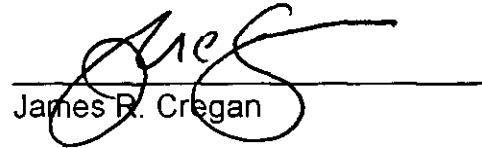
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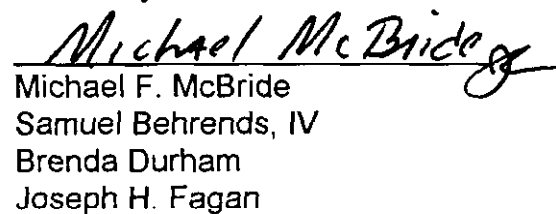
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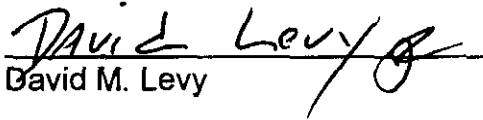
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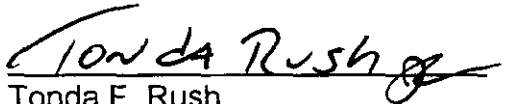

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document on all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.


James R. Cregan

April 1, 1998